From the Editors

At last, we are pleased to offer our Summer/Fall issue of Business Tax Quarterly. We have pulled together a variety of topics we think are important to business lawyers of all stripes, certainly not only the tax specialist. Charolette Noel, Anthony Dick and Mark Rotatori from Jones Day offer an analysis of the recent Comptroller v. Wynne decision holding Maryland's personal income tax violated the US Constitution's Commerce Clause. Michael Melbinger of Winston & Strawn provide a summary of recent changes to the Section 83(b) election rules, while a team of authors from Proskauer Rose explains the important proposed IRS regulations on private equity management fee waivers. Jim Croker and Stefanie Kavanagh of Alston & Bird in DC describe recent guidance from the IRS with wide-ranging impact on public company spins. Last but not least, Allen Sullivan of Burr Forman brings us up to date on an area of increasing IRS scrutiny and enforcement - employee versus independent contractor status.

As always, we would really like to hear from you with feedback, including criticism and suggestions for improvement. Also, we could use more help on the editorial side. So if you have an interest and a little time, no prior experience is necessary and certainly don't worry about tax credentials. Needless to say, we are always looking for good content, especially from our committee members. Please contact Jennifer or Mike if you are interested in contributing an article.

Finally, as editor and as recently outgoing chair of the Taxation Committee, I want to welcome and offer my congratulations to our new chair, Roger Royse. Roger is off to a great start, as in part reported in the remarks from the chair.

Wishing you all pleasant holidays and a comfortable winter.

Michael Kliegman
Former Chair, Taxation Committee

Message from the Chair

Dear Members:

With this issue of the Business Tax Quarterly newsletter, I would like to introduce myself as the incoming Chair of the Business Law Section Taxation Committee and welcome you to our numerous upcoming events. We had two very successful programs at the fall meetings in Chicago in September. Your Tax Committee teamed up with the PEVC to present a very well-attended panel on International Funds, including US and foreign tax aspects of outbound fund investment. We also were fortunate to welcome Professor Annette Nellen to our committee meeting to discuss hot topics in tax.

Many of you responded to my call for speakers last month and we will have a packed agenda for Montreal in April, 2016. In addition to our committee meeting, which will include a presentation on US-Canada cross border employment tax issues, we are teaming up with the Business Bankruptcy Committee for a program on distressed company sales, and the M&A Committee for tax considerations in domestic and international M&A transactions. The Montreal meetings promise to provide a wide variety of content.

In addition to the live panels at the upcoming Spring meeting, the Section will be
broadcasting Tax Committee webinars on more specific topics, including municipal financing and business succession planning. You should contact me if you or someone in your firm would like to participate in a presentation or webinar.

The Tax Committee now has an ABA Fellow, Dan Knudsen, to help us with updating our website. We will be working to include our upcoming activities online. Stay tuned for our new and improved website.

This will be a very active year for the Tax Committee, and we will be seeking suggestions, content and speakers. In particular, the Tax Committee would like to encourage some of our younger lawyers to take an active role and use this Committee as an opportunity to gain exposure or sharpen skills. I am looking forward to seeing how the year unfold for our members.

Roger Royse
Chair, Taxation Committee

Feature Articles

Proposed Regulations Issued On Management Fee Waivers

On July 22, 2015, the U.S. Department of the Treasury and U.S. Internal Revenue Service issued proposed Treasury Regulations under Section 707(a)(2)(A) of the Internal Revenue Code of 1986, as amended, addressing management fee waiver arrangements. Under the Proposed Regulations, certain management fee waiver arrangements will be treated as disguised payments for services for U.S. federal income tax purposes, resulting in ordinary income treatment (and possibly significant penalties under deferred compensation rules). The Proposed Regulations also cover additional matters that are beyond the scope of this client alert.

While the Proposed Regulations are not technically effective unless and until the date final regulations are published, the Treasury Department and IRS believe that the Proposed Regulations generally reflect current law. In other words, the government's position is that the core principles outlined in the Proposed Regulations apply under current law.

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Comptroller of the Treasury of Maryland v. Wynne: What Are the Potential Consequences?

By Anthony Dick, Charolette Noel and Mark Rotatori

On May 18, 2015, in Comptroller of the Treasury of Maryland v. Wynne, the United States Supreme Court held that Maryland's personal-income-tax scheme violated the dormant Commerce Clause. The Maryland tax scheme was found to be comparable to other unconstitutional tax schemes that had the potential to result in discriminatory double taxation of income earned out of state, that created a powerful incentive to engage in intrastate rather than interstate economic activity, and that were not cured by satisfying the "internal consistency" test.

Wynne involved a challenge to the joint operation of two components of Maryland's personal income tax: the "state" income tax (Md. Tax-Gen. Code Ann §10105(a)) and the "county" income tax (§§10103, 10106). Maryland residents who paid personal income tax in another jurisdiction received a credit against Maryland's "state" tax for taxes paid to those other jurisdictions, but they did not receive a credit against the "county" tax. Additionally, non-residents who earned income within Maryland paid both the "state" income tax and an additional "special nonresident tax" in lieu of the "county" tax.

Read more....

Why, Again, Do You Think that Worker is an Independent Contractor
By Allen Sullivan

If you're reading this article, then you likely own or administer a medical practice of some sort. That practice may have workers of many stripes. Some of those workers may be treated as employees and some may be independent contractors. For example, some home health workers may be paid as independent contractors while others are not. If you help run a hospital, you may have noticed that some hospital doctors are considered contractors yet others are employees. But do you know why they are treated that way? Well, if the IRS or the Alabama Department of Revenue audits your practice, you may need to know why quickly.

Read more....

IRS proposes regulations to ease the filing of 83(b) elections
By Michael S. Melbinger

Section 83(b) allows an individual (executive or employee) to elect to recognize taxable income immediately upon the receipt of restricted stock or other property subject to a risk of forfeiture, even though the stock remains subject to a vesting schedule and the individual might later forfeit the property.

As readers know, Section 83(b) allows an individual (executive or employee) to elect to recognize taxable income immediately upon the receipt of restricted stock or other property subject to a risk of forfeiture, even though the stock remains subject to a vesting schedule and the individual might later forfeit the property. Many executives file an 83(b) election as to restricted stock awards (and all executives file an 83(b) election as to profits interests from an LLC). Generally, they do this to start the long-term capital gains rate holding and taxation period.

Read more....

Qualification of Certain Section 355 Spinoff Transactions Added to No-Rule List

On September 14, 2015, the IRS released Notice 2015-59 and Rev. Proc. 2015-43, both relating to Section 355 spinoffs. They respond to government concerns about spinoff transactions that result in the distributing corporation or the controlled corporation owning a substantial amount of cash, portfolio stock, securities or other investment assets in relation to the value of all of its assets and its qualifying business assets. In the Notice, the IRS states that it has become aware, in part through private letter ruling requests, that these transactions may present evidence of device for distribution of earnings and profits, may lack an adequate business purpose or a qualifying business, or may violate other Section 355 requirements. In response to the government's concerns, Notice 2015-59 explains that the IRS and Treasury are studying issues under Sections 337(d) and 355 regarding certain distributions. In light of the IRS's intent to further study issues pertaining to Section 355, Rev. Proc. 2015-43 amends the no-rule Revenue Procedure, Rev. Proc. 2015-3, to include certain spinoff transactions.

Read more....
Proposed Regulations Issued On Management Fee Waivers

posted on: Sunday, July 26, 2015

On July 22, 2015, the U.S. Department of the Treasury and U.S. Internal Revenue Service issued proposed Treasury Regulations under Section 707(a)(2)(A) of the Internal Revenue Code of 1986, as amended, addressing management fee waiver arrangements.[1] Under the Proposed Regulations, certain management fee waiver arrangements will be treated as disguised payments for services for U.S. federal income tax purposes, resulting in ordinary income treatment (and possibly significant penalties under deferred compensation rules). The Proposed Regulations also cover additional matters that are beyond the scope of this client alert.

While the Proposed Regulations are not technically effective unless and until the date final regulations are published, the Treasury Department and IRS believe that the Proposed Regulations generally reflect current law. In other words, the government's position is that the core principles outlined in the Proposed Regulations apply under current law.[2]

Management Fee Waiver Arrangements

In a typical management fee waiver arrangement, the general partner of a private investment fund (owned by the fund managers) is permitted to satisfy all or a portion of its capital commitment to the fund with "deemed" capital contributions, and the fund managers similarly are deemed to satisfy all or a portion of their capital contribution obligations to the general partner. In connection with the deemed contribution, there is a reduction in the management fee payable by the fund (where the fee is payable either to the general partner or to a management company owned by one or more of the owners of the general partner of the fund).

The general partner is entitled to a priority allocation of subsequent net profits of the fund, if and when they occur, equal to the amount of its deemed capital contributions to the fund. If such priority profit allocation includes net long-term capital gain or qualified dividend income, the fund's general partner (and its partners) would be subject to tax at the lower U.S. federal capital gains tax rate as compared to the higher ordinary income tax rate that otherwise would have applied to the waived management fee. The priority allocation may also result in deferral of the tax that would have been due if management fees had not been waived.

Analysis of Management Fee Waiver Arrangements Under Proposed Regulations

The Proposed Regulations provide that whether an arrangement between a partner and a partnership constitutes a payment for services depends on all of the facts and circumstances, and identifies six non-exclusive factors to consider. The most important factor is the entrepreneurial risk of the arrangement -- an arrangement that lacks significant entrepreneurial risk is treated as a payment for services without regard to any other factor.[3] The five other factors identified by the Proposed Regulations that are indicative of a disguised payment for services:

(i) the service provider holds, or is expected to hold, a transitory partnership
interest or a partnership interest for only a short duration;

(ii) the service provider receives an allocation and distribution in a time frame comparable to the time frame that a non-partner service provider would typically receive payment;

(iii) the service provider became a partner primarily to obtain tax benefits that would not have been available if the services were rendered to the partnership in a third party capacity;

(iv) the value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution; and

(v) the arrangement provides for different allocations or distributions with respect to different services received, the services are provided either by one person or by persons that are related under Sections 707(b) or 267(b) of the Internal Revenue Code, and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.^[4]

**Significant Entrepreneurial Risk**

As noted above, the Proposed Regulations treat a management fee waiver arrangement that lacks significant entrepreneurial risk as a payment for services. An arrangement that has significant entrepreneurial risk generally will not constitute a payment for services, unless other factors establish otherwise. Whether an arrangement lacks significant entrepreneurial risk is based on the service provider's entrepreneurial risk relative to the overall entrepreneurial risk of the fund.^[5]

Under the Proposed Regulations, each of the following facts and circumstances creates a presumption that an arrangement lacks significant entrepreneurial risk and will be treated as a disguised payment for services unless other facts and circumstances establish the presence of significant entrepreneurial risk by clear and convincing evidence:

(i) capped allocations of partnership income if the cap is reasonably expected to apply in most years;

(ii) an allocation for one or more years under which the service provider's share of income is reasonably certain;

(iii) an allocation of gross income;

(iv) an allocation (under a formula or otherwise) that is predominantly fixed in amount, is reasonably determinable under all the facts and circumstances, or is designed to assure that sufficient net profits are highly likely to be available to make the allocation to the service provider (e.g., if the partnership agreement provides for an allocation of net profits from specific transactions or accounting periods and this allocation does not depend on the long-term future success of the enterprise); or

(v) an arrangement in which a service provider waives its right to receive payment for the future performance of services in a manner that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms.^[6]

**Examples in Proposed Regulations**

The Proposed Regulations include examples of management fee waiver arrangements that presumptively lack significant entrepreneurial risk and those that do have significant entrepreneurial risk.

A management fee waiver arrangement was determined to presumptively lack significant entrepreneurial risk where the priority allocation in respect of the management fee waiver arrangement was an allocation of net profit from any 12-month accounting period in which the partnership had net gain (as a result, the allocation did not depend on the overall success of the enterprise). In this example, the sale of assets by the partnership (and hence the timing of recognition of gains and losses) was controlled by the general partner of the partnership, a company related to the service provider receiving the priority allocation of profit in respect of the management fee waiver arrangement.^[7]
By contrast, a management fee waiver arrangement was determined to have significant entrepreneurial risk where the interest consisted of future partnership net income and gains, the allocation was subject to a clawback obligation to the extent that, over the life of the fund, the share of future partnership net income and gain was in excess of the fund’s net profit, it was reasonably anticipated that the clawback obligation could and would be complied with, and the allocation was neither reasonably determinable nor highly likely to be available. There were no additional facts and circumstances suggesting that the arrangement was properly characterized as a payment for services.[8]

**Certain Transactions Not Within IRS Revenue Procedure 93-27**

The receipt of a "profits interest" that is covered by IRS Revenue Procedure 93-27 is not a taxable event. The preamble to the Proposed Regulations includes a statement that the Treasury Department and IRS have determined certain transactions in which one party provides services and another party receives an associated allocation and distribution of partnership income or gain are not treated as the grant of a "profits interest" that satisfies the requirements of IRS Revenue Procedure 93-27.[9] For example, the IRS Revenue Procedure would not apply where a management company that provides services to a fund in exchange for a fee waives that fee, and a party related to the management company receives an interest in future partnership profits the value of which approximates the amount of the waived fee.[10] This determination by the Treasury Department and IRS leaves open the possibility of challenging the valuation and taxation of the receipt of such a partnership interest.

**Next Steps**

Fund managers should review any potential or existing management fee waiver arrangements in light of the Proposed Regulations. The Proposed Regulations mandate no gross income allocations and the examples strongly suggest that the management fee waiver arrangement should be economically at risk – and supported by an enforceable return obligation – to the extent amounts received by reason of the fee waiver exceeds the cumulative net profits over the life of the fund. Accordingly, fund managers should consider structuring their arrangements to conform with these guidelines.

[1] The Proposed Regulations can be found here.


[10] Id.

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Comptroller of the Treasury of Maryland v. Wynne: What Are the Potential Consequences?¹

By Anthony Dick, Charolette Noel and Mark Rotatori²

On May 18, 2015, in Comptroller of the Treasury of Maryland v. Wynne, the United States Supreme Court held that Maryland’s personal-income-tax scheme violated the dormant Commerce Clause.³ The Maryland tax scheme was found to be comparable to other unconstitutional tax schemes that had the potential to result in discriminatory double taxation of income earned out of state, that created a powerful incentive to engage in intrastate rather than interstate economic activity, and that were not cured by satisfying the “internal consistency” test.

Wynne involved a challenge to the joint operation of two components of Maryland’s personal income tax: the “state” income tax (Md. Tax-Gen. Code Ann §10105(a)) and the “county” income tax (§§10103, 10106). Maryland residents who paid personal income tax in another jurisdiction received a credit against Maryland’s “state” tax for taxes paid to those other jurisdictions, but they did not receive a credit against the “county” tax. Additionally, non-residents who earned income within Maryland paid both the “state” income tax and an additional “special nonresident tax” in lieu of the “county” tax.

The Wynnes challenged these aspects of Maryland’s personal income tax as violations of the Commerce Clause because, as a result of the Maryland tax regime, they were double-taxed on certain portions of their income—once by the state in which it was earned and a second time in Maryland, which did not provide a full credit to offset the out-of-state tax. The Wynnes argued that this double-taxation scheme discriminated against interstate commerce because it burdened interstate income more heavily than intrastate income, and thus incentivized Maryland residents to earn income within the state rather than across state lines.

In a 5-4 decision,⁴ the Supreme Court agreed, holding that Maryland’s tax scheme violated the dormant Commerce Clause. The majority opinion, written by Justice Alito, found the tax scheme indistinguishable from certain corporate taxes that the Supreme Court had previously struck down. Like those invalidated corporate taxes, Maryland’s personal-income tax

¹ This article was originally published in the BNA Tax Management Weekly State Tax Report and BNA Tax Management State Tax Library. The article is reprinted with permission from Tax Management Weekly State Tax Report, Perspective, 06/12/2015. Copyright (c) 2015 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com.

² Anthony Dick, Esq., is an associate in the Washington office of Jones Day. Charolette Noel, Esq., is a partner in the Dallas office of Jones Day. Mark Rotatori, Esq., is a partner in the Chicago office of Jones Day. The views set forth in this article are the personal views of the authors and do not necessarily reflect the opinions of Jones Day, its clients, or any other organizations with which the authors are associated.


⁴ Interestingly, within an hour after the Supreme Court heard oral arguments, this 5-4 decision was predicted at a panel discussion hosted by Council On State Taxation (COST), Bloomberg BNA and Jones Day. See Special Report – Comptroller v. Wynne: Post Oral Argument Predictions and Analysis, 34 TAX MANAGEMENT MULTISTATE TAX REPORT, no. 12, December 26, 2014, at S-7 (Expert Panel Makes Predictions and Analyzes Policy Implications About High Court Oral Arguments in ‘Comptroller v. Wynne’), S-13 (Dormant Commerce Clause Foes Scalia and Thomas Likely to Side with Maryland Along with Kagan and Ginsburg, Panelists Say).
not only taxed income earned by non-residents within its borders, but also taxed income earned by Maryland residents in other states, while refusing to give them a credit for the income taxes they paid in those other states. The Court held that this tax scheme violated the dormant Commerce Clause because it “had the potential to result in discriminatory double taxation of income earned out of state and created a powerful incentive to engage in intrastate rather than interstate economic activity.”5 The Court explained that it has “long held that States cannot subject corporate income to tax schemes similar to Maryland’s,” and it saw “no reason why income earned by individuals should be treated less favorably.”6

Four Justices dissented in three separate opinions by Justices Scalia, Thomas, and Ginsburg, whom Justices Scalia and Kagan joined. This lineup illustrates that although the Court is sharply divided in dormant Commerce Clause cases, the division does not fall along traditional ideological lines. Justice Scalia’s and Justice Thomas’s main disagreement was not with the majority’s application of precedent, but rather with the very notion that Constitution contains any “dormant” Commerce Clause at all. As Justice Scalia wrote in his dissent (joined in relevant part by Justice Thomas), “[t]he fundamental problem with our negative Commerce Clause cases is that the Constitution does not contain a negative Commerce Clause. It contains only a Commerce Clause.”7 Based on that view, Justice Scalia has repeatedly stated that he will apply the “dormant” Commerce Clause only for the sake of stare decisis, and will thus strike down laws only if they are completely indistinguishable from laws the Court has previously invalidated. Justice Thomas has gone even farther, saying that he will not apply the dormant Commerce Clause at all.

By contrast, Justice Ginsburg’s dissent (joined by Justices Scalia and Kagan) accepted the validity of the Court’s dormant Commerce Clause jurisprudence, but argued that Maryland’s tax scheme should nonetheless survive. Although she recognized that Maryland’s personal-income-tax scheme bore some resemblance to corporate tax schemes previously struck down, she distinguished those cases on the ground that they involved gross-receipts taxes rather than personal-income taxes (a distinction that the majority rejected as irrelevant). Justice Ginsburg contended that Maryland’s tax scheme must be upheld in order to respect the unconditional right of each sovereign state to tax the full income of its own individual residents, who receive unique benefits from their home state.8

In response to this last point, the majority answered that states do have the right to tax the full income of their residents, as long as their overall tax scheme does not discriminate against or unduly burden interstate commerce. Hence, the problem with Maryland’s tax scheme was not simply that it taxed the full income of its residents, including income they earned out-of-state, but also that it taxed the income that non-residents earned within Maryland, without providing any offsetting credit. Consequently, the majority explained, Maryland’s tax scheme violated the

5 Id. at 1801-1802.
6 Id. at 1792.
7 Id. at 1808 (Scalia, J., dissenting).
8 Id. at 1814 (Ginsburg, J., dissenting).
“internal consistency” test, which the Court had applied in at least seven previous dormant Commerce Clause tax cases.

The internal-consistency test asks whether interstate and intrastate commerce would be taxed equally if every state were to adopt the precise tax scheme at issue. As Justice Alito explained in his opinion for the Court, “[b]y hypothetically assuming that every State has the same tax structure, the internal consistency test allows courts to isolate the effect of a defendant State’s tax scheme.”9 As the Supreme Court has explained elsewhere, “[a] failure of internal consistency shows as a matter of law that a State is attempting to take more than its fair share of taxes from the interstate transaction.”10 The bottom line is that if a state like Maryland wants to tax income earned by non-residents within its borders, then it must give its own residents a credit for the taxes they pay in other states. Alternatively, if a state wants to tax the full income of its own residents, then it cannot tax the income of non-residents. A state can choose one option or the other, but it cannot choose both. Because Maryland tried to choose both, its tax scheme violated the internal-consistency test.11

_Wynne_ is thus highly significant for its holding that internally inconsistent state personal-income-tax schemes violate the dormant Commerce Clause. This ruling goes a long way towards clarifying whether the credits that some states afford their residents for income taxes paid in other states are merely a matter of policy or a constitutional requirement. This decision breathing substantial new life into the internal-consistency test, which, as Justice Ginsburg’s dissent pointed out, had not been used to strike down a state tax law for nearly 30 years.12 In the near term, the Court’s decision may have a serious economic impact on certain state and local governments, as well as taxpayers. Early estimates predict that Maryland will be responsible for approximately $200 million in tax refunds to over 55,000 Maryland taxpayers. Approximately $115 million of this amount is attributable to taxpayers in Montgomery County alone. In addition, several other states, including New York, Indiana, and Pennsylvania, have municipalities with similar tax schemes that might require overhaul in the wake of this decision.13

Several legal questions also remain as a result of the Court’s decision. For example, it is unclear how the holding in _Wynne_ will affect municipalities that collect their own income taxes at the municipal level. Unlike Maryland, which levied its local taxes at the state level and then redistributed the local taxes to the localities, municipalities that collect their taxes at the local level could argue that they are not subject to the “interstate” Commerce Clause. It is also unclear whether the Court’s rejection of the argument that the Commerce Clause distinguishes between gross receipts taxes and income taxes—at least with respect to the discrimination standard—can

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9 Id., at 1802.
11 _Wynne_, 135 S.Ct. 1803-06.
12 _Id._ at 1820-21 (Ginsburg, J., dissenting).
be read to mean that the physical presence standard of nexus established in *Quill Corp.* should be consistently applied among different taxers.\textsuperscript{14}

Further, the Court did not decide how an offending state should remedy the constitutional defect in a tax scheme that fails the internal-consistency test. The Court emphasized that states retain flexibility in deciding how they will satisfy the test: States are not strictly required to provide their residents with tax credits for income earned in other states, as long as they do not tax income earned within their borders by non-residents. States like Maryland must simply choose either to stop taxing non-resident income, or else give their resident taxpayers credit for income taxes paid in other states. The Constitution leaves it up to the states to make this choice of remedies, as long as they do not run afoul of other requirements such as “fair apportionment” or “external consistency.”\textsuperscript{15}

Because the internal-consistency test respects federalism by allowing different states to make different choices as to the tax schemes they will adopt, it leaves room for the possibility that some double taxation may legitimately result from the overlap of two different state tax regimes, if those regimes are both internally consistent. So, for example, if Maryland taxed only income of its residents (but wherever earned) while Virginia taxed only income earned within its borders (but wherever the earner resided), then a Maryland resident earning income in Virginia would pay tax on that income to both States. Yet both States’ tax schemes would be “internally consistent.” Accordingly, as this hypothetical shows, the mere fact of double taxation alone is not enough to show a constitutional violation under the dormant Commerce Clause. Nonetheless, this possibility may prove to be more hypothetical than real, since few jurisdictions refuse to provide credits for local residents who pay income taxes elsewhere.

\textsuperscript{14} *Quill Corp. v. North Dakota*, 504 U.S. 298, 305(1992), was cited favorably in *Wynne* for distinguishing when a state may have authority to tax a particular taxpayer consistent with the Due Process Clause but the imposition of such tax may nonetheless violate Commerce Clause requirements. Because the taxpayers in *Wynne* were residents of Maryland, sufficient nexus for taxation was not at issue in the case.

Why, Again, Do You Think that Worker is an Independent Contractor  

By Allen Sullivan

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If you're reading this article, then you likely own or administer a medical practice of some sort. That practice may have workers of many stripes. Some of those workers may be treated as employees and some may be independent contractors. For example, some home health workers may be paid as independent contractors while others are not. If you help run a hospital, you may have noticed that some hospital doctors are considered contractors yet others are employees. But do you know why they are treated that way? Well, if the IRS or the Alabama Department of Revenue audits your practice, you may need to know why quickly.

The Economics of Worker Classification

Since 2008 many companies have cut costs wherever possible, which often involves using independent contractors whenever possible. Why? Employees are much more expensive than independent contractors. Employees cast many burdens on their employers: health care benefits, minimum wage limitations, fringe benefit costs. None of these issues arise with independent contractors.

In addition to administrative burdens, employees also cost their employers much more in employment tax than independent contractors. You see, all employers must generally pay employment taxes (Social Security, FICA, etc.) of around 7.5% of each employee's salary. There is no similar requirement related to independent contractors; they are responsible for their own employment taxes. Using the national income average of $43,000, an average employee costs its employer about $3,700 more than an average independent contractor in tax-related costs alone. Thus, all other things being equal, businesses treating their workers as independent contractors have competitive advantages over those treating similar workers as employees.

Independent Contractor or Employee?

Because the worker classification decision so affects the bottom line, many companies prefer to classify their workers as independent contractors. But what makes one worker an employee and another an independent contractor? In a word: control. If a company has control over how a worker performs his or her job, then that worker is most likely an employee. The substance of the worker/company relationship therefore determines the worker's classification, no matter how the company and the worker decide to define the relationship. That is, you cannot simply label your worker an independent contractor and expect the IRS or some other government agency to take your word for it.

Since 1987 the IRS has used a "20 Factor Test" to determine whether or not a business has control over a worker. Each factor indicates control or a lack of control, and, in turn, either employee or independent contractor status. For example, if you require your workers to attend formal training, then your control indicates employee status. Control is also evident if a worker must work set hours, gets paid by the hour, or can be terminated at any time. On the other hand, if a worker is paid on a per-task basis, does the same type of work for other companies, and provides its own tools and equipment, then the paying company doesn't likely control the worker enough to trigger employee status.
Why Should You Care? Increased Audits

Back in 2009, the Government Accountability Office ("GAO") took the IRS to task for its ineffective enforcement of employment tax compliance. The so-called "tax gap" -- the gap between taxes owed and those actually paid -- was widening at this time, and employment tax issues, like the misclassification of workers as independent contractors, played a significant part. The GAO report estimated that worker misclassification alone accounts for $1.8 billion of the tax gap. The U.S. Department of Labor estimated additional unemployment insurance revenue losses to be in the $400 million to $600 million range.

Soon after the GAO report’s release, the IRS responded by announcing a "National Research Program" ("NRP") -- the first of its type since 1984 -- to address issues that surfaced in the GAO report. In reality the NRP was more like a massive audit initiative. The IRS used the NRP to audit 6,000 U.S. companies, targeting broad cross-sections of employers nationwide: corporations and pass-through entities, profitable entities and those in-the-red, and operations large and small. Among other things, these audits analyzed the companies' worker classification decisions.

Armed with NRP data the IRS is identifying noncompliance patterns and using this information to audit others. Will the IRS again target health care companies like they did in the '90s after concluding a similar research project? We don't know yet, but the employment tax world seems to run in cycles, and federal and state governments are under stress to plug widening budget holes.

In any event, the IRS clearly plans to intensify its worker classification audits. This audit uptick may also relate to the Affordable Care Act's ("ACA") requirement that companies with 50 "full-time equivalent" employees must offer those employees health insurance. The IRS may worry that ACA-related burdens will tempt more and more companies to attempt illegitimate contractor use. Any companies considering moving to a contractor-heavy workforce because of the ACA, or for other reasons, should therefore evaluate whether those workers may be reclassified as employees in an IRS audit.

Prepare Now

Companies can prepare for government scrutiny by reviewing their own compliance procedures, and perusing contracts with would-be independent contractors. You may be able to avoid many costly penalties by disclosing past missteps to the IRS before an audit.

And if you are audited, then time is of the essence. Establish a proper "chain of command" to ensure that important notices, and their more important deadlines, don't go unaddressed. Additionally, companies need procedures in place that guarantee that outside advisors are notified right away. Involving tax practitioners early in an audit may allow them to narrow the audit's scope, and thereby reduce the costs of defending it. Spending a little time and money now can save a lot of both later.

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On September 14, 2015, the IRS released Notice 2015-59 and Rev. Proc. 2015-43, both relating to Section 355 spinoffs. They respond to government concerns about spinoff transactions that result in the distributing corporation or the controlled corporation owning a substantial amount of cash, portfolio stock, securities or other investment assets in relation to the value of all of its assets and its qualifying business assets. In the Notice, the IRS states that it has become aware, in part through private letter ruling requests, that these transactions may present evidence of device for distribution of earnings and profits, may lack an adequate business purpose or a qualifying business, or may violate other Section 355 requirements. In response to the government’s concerns, Notice 2015-59 explains that the IRS and Treasury are studying issues under Sections 337(d) and 355 regarding certain distributions. In light of the IRS’s intent to further study issues pertaining to Section 355, Rev. Proc. 2015-43 amends the no-rule Revenue Procedure, Rev. Proc. 2015-3, to include certain spinoff transactions.

**Background**

Section 355 allows corporations to distribute the stock of a controlled corporation to shareholders without incurring income, gain or loss on the distribution for tax purposes so long as certain requirements are met. Corporations taking advantage of this provision, which is not applicable if the transaction is primarily intended to distribute the company’s or its controlled corporation’s earnings and profits, must be actively conducting business immediately following the distribution. Additionally, the transaction must be carried out in order to satisfy a business purpose.

The IRS has indicated uneasiness with granting permission to companies seeking to do spinoffs with significant proportions of cash-like securities. In July 2015, the IRS announced that it was studying possible administrative guidance relating to certain issues under Section 355, including the active trade or business requirement.1

Of note, the issuance of Notice 2015-59 and Rev. Proc. 2015-43 came less than a week after the IRS declined to rule on a planned spinoff by Yahoo! Inc. of its Alibaba Group Holding Ltd. stock and Yahoo Small Business unit. Additionally, the issuance of the Notice and Revenue Procedure came after months of discussion about Darden Restaurant Inc.’s planned real estate investment trust spinoff using the OpCo-PropCo structure. It does not appear that the issuance of the Notice and Revenue Procedure has dissuaded either Yahoo! or Darden Restaurant Inc. from continuing with their planned spinoffs.

**Notice 2015-59**

The Notice states that the IRS and Treasury are studying issues relating to transactions involving one or more of the following characteristics: (1) ownership by the distributing

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corporation or the controlled corporation of investment assets having substantial value in relation to the value of all of such corporation’s assets and the value of the assets of the active trade or business on which the distributing corporation or the controlled corporation relies to satisfy the requirements of Section 355(b); (2) a significant difference between the distributing corporation’s ratio of investment assets to assets other than investment assets and such ratio of the controlled corporation; (3) ownership by the distributing corporation or the controlled corporation of a small amount of qualifying business assets in relation to all of its assets; and (4) an election by the distributing corporation or the controlled corporation (but not both) to be a regulated investment company (RIC) or a real estate investment trust (REIT).

The Notice states that the IRS and Treasury are most concerned about transactions that result in the following: (1) the distributing corporation or the controlled corporation owning a substantial amount of cash, portfolio stock, securities or other investment assets in relation to the value of all of its assets and its qualifying business assets; and (2) one of the corporations having a significantly higher ratio of investment assets to non-investment assets than the other corporation. The Notice also states that there is concern about increasing numbers of REIT spinoffs.

The IRS and Treasury request comments concerning the transactions described in the Notice.

**Rev. Proc. 2015-43**

Rev. Proc. 2015-43 makes three additions to Rev. Proc. 2015-3, which serves as a list of areas in which the IRS will not issue letter rulings or determination letters. The areas listed in Rev. Proc. 2015-3 are commonly referred to as “no rules.” Rev. Proc. 2015-43 will apply to all ruling requests that were postmarked or, if not mailed, received on or after September 14, 2015.

Two no-rules are added to Section 4 of Rev. Proc. 2015-3, which sets forth areas in which the IRS will not ordinarily issue rulings or determination letters barring any unique or compelling reasons to do so: (1) spinoffs enabling a C corporation to transfer its property tax-free to a REIT or RIC unless both the distributing corporation and the controlled corporation will both be RICs or will both be REITs immediately after the redistribution; and (2) spinoffs in which the value of the active trade or business in either the distributing corporation or controlling corporation is less than 5 percent of the total fair market value of the gross assets.

Interestingly, the 5 percent active trade or business requirement is not a novel development. Between 1996 and 2003 there was a requirement that the value of the active trade or business in either the distributing corporation or controlling corporation could not be less than 5 percent of the total fair market value of the gross assets.

One no-rule is added to Section 5 of Rev. Proc. 2015-3, which is reserved for matters under study by the IRS and Treasury. The IRS is prohibited from issuing rulings or
determination letters on issues included in Section 5 until the IRS resolves the issue through publication of guidance. The no-rule added to Section 5 relates to the qualification of a distribution where all of the following conditions exist immediately after the distribution: (1) the fair market value of the investment assets of either the controlled corporation or the distributing corporation is two-thirds or more of the value of its gross assets; (2) the fair market value of the active trade or business assets of either the controlled corporation or distributing corporation is less than 10 percent of the value of its investment assets; and (3) the ratio of the fair market value of the controlled corporation’s investment assets to that of its other assets is three or more times greater than the ratio found in the distributing corporation or vice versa.

This no-rule added to Section 5 of Rev. Proc. 2015-3 seems very similar to the language of Section 355(g) of the Code. That section provides that “disqualified investment corporations” are not able to take advantage of the benefits of Section 355. This similarity raises the question of why Section 355(g) was not adequate to stop certain investment corporations from taking advantage of the benefits of Section 355 – why was this no-rule even necessary?

A more careful reading of both Section 355(g) and this particular no-rule shows that the no-rule uses a broader definition of “investment assets,” expanding on the definition used in Section 355(g). Rev. Proc. 2015-43 provides that, for purposes of the no-rule, the definition of “investment assets” has the meaning given by Section 355(g)(2)(B), except as follows:

- (i) Publicly traded stock is an investment asset unless the distributing corporation or controlled corporation owns 50 percent (by vote and value) of such stock (increased from the 20 percent threshold in Section 355(g)(2)(B)(iv));
- (ii) Except as provided in clause (iv), an interest in a publicly traded partnership is treated in the same manner as publicly traded stock;
- (iii) Except as provided in clause (iv), an interest in a partnership that is not a publicly traded partnership is treated in the same manner as stock that is not publicly traded stock; and
- (iv) An interest in a partnership (other than a publicly traded partnership treated as a corporation pursuant to Section 7704(a)) is not an investment asset if the active trade or business of such partnership is taken into account by the distributing corporation or the controlled corporation, or would be so taken into account without regard to the five-year requirement of Section 355(b)(2)(B).

What to Expect

It is difficult to predict what these additional no-rules mean for certain Section 355 spinoffs in the future. At the September 19th ABA meeting, Robert Wellen, IRS associate chief counsel (corporate), stated that the content of the Notices "is by no means a description of future guidance . . . It's a description of concerns that we hope will lead to future guidance or we think will lead to future guidance in some form. There's nothing
in this notice that would suggest a retroactive effective date to last Monday." However, at the DC Bar Taxation Section meeting on September 29th, Wellen was less reassuring that the reasoning in the notice doesn't reflect a definitive change in the IRS's interpretation of the law.

For additional information, call Jim Croker at 202.239.3309 or Stefanie Kavanagh at 202.239.3914.